

UPDATE ON FICA WITHHOLDING ON EMPLOYEE PENSION CONTRIBUTIONS

J. W. Bryan

*State Social Security Administrator
Finance and Administration Cabinet*

On May 13, 2014, Two Area District Managers of the Internal Revenue Service (IRS) met with representatives of the Personnel Cabinet and the Finance and Administration Cabinet concerning reporting of Social Security Tax liabilities by Kentucky's governmental employers. As the State Social Security Manager with the filing responsibilities for the Commonwealth, I was part of the meeting.

The method that the Commonwealth and most government employers in Kentucky calculated their Social Security tax liability and Medicare tax liability for each payroll by deducting the employee's pension contributions from employee's gross wages to arrive at taxable FICA wages was the subject. The correct way should have been to include the employee's pension contributions in the taxable wages.

Beginning in 1983, Congress and Kentucky passed legislation that under 414(h) of the United States Internal Revenue Code, removed these pension contributions from the employee's gross income until such time they were distributed by the pension system. This legislation exempted these payments if the employer through withholdings paid the retirement deductions directly to the retirement system. The legal term is "picked up and paid".

In 1987, additional legislation was passed by Congress to allow the retirement system withholdings to be exempted from Social Security tax provided that such "picked up" payments were not made pursuant to a salary reduction agreement. Congress did not define a salary reduction agreement.

From 1987 until present, governmental employers in Kentucky have calculated their FICA tax liabilities under the IRS's Private Letter Ruling 8718032 that stated under our statutes retirement withholdings were not wages for purposes of the FICA provided that they were not picked up pursuant to a salary reduction agreement.

In 1998, the Tenth Circuit of the United States Court of Appeals ruled in "Public Employees Retirement Board v. Shalala" that reducing the gross wages by the retirement withholdings to calculate FICA taxes was a salary reduction agreement. This is the method that Kentucky uses.

In another Court of Appeals case, the opposite of a salary reduction agreement was described as a salary supplement agreement, where the employer would pay the employees retirement contributions in addition to their gross wages.

Since the Tenth Circuit Court decision, the IRS has been addressing these private letter rulings with each respective state. It is our understanding that Kentucky is the last state to be addressed.

The IRS required that Kentucky prepare a reasonable plan to change the treatment of the pension contributions to bring the state into compliance for calculating FICA and Medicare contributions effective December 31, 2015.

Through a series of negotiations, the Commonwealth resolved this dispute by contractually being assured that no past liability would be owed by government agencies and second, that the new calculation would be effective January 1, 2017 to give agencies adequate time to plan for budgeting purposes, make changes to payroll systems, and communicate effectively with all impacted employers and employees.

Under a Memorandum of Agreement effective January 1, 2017, taxable FICA wages will include the employees' pension contributions. But, the employer will continue to deduct Cafeteria Plan expenditures.

This settlement affects all governmental employers in the various retirement plans, including the Executive, Legislative and Judicial Branches of state government, eight universities and KCTS, and 1,471 counties, city and local school districts. The state estimates that the additional annual cost will be approximately \$5.7 million for state government agencies alone.

Both the governmental employers and their employees will each have to pay the increased amount. An example of the increased cost per employee is attached.

Note that for employees who participate in Social Security, the additional contributions will result in increased Social Security benefits upon retirement.

For income tax, the employee retirement withholdings continue to be exempt.

IRS MEMORANDUM OF AGREEMENT
EXAMPLE CALCULATION FOR COST TO EMPLOYEES AND EMPLOYERS PER PAY PERIOD
Beginning January 1, 2017

Rev. 8-11-2015

ASSUMPTIONS:

Average Annual Salary = \$40,500
Monthly Salary = \$3,375
Semi-monthly = \$1,687.50

FICA = 6.2%
*Medicare = 1.45%

	KY RET SYSTEM KERSICERS		KY RET SYSTEM-HAZARDOUS KERSICERS/KSP		JUDICIAL & LEGISLATIVE RET SYSTEM		OTHER RETIREMENT SYSTEMS TIAA-CREF UNIVERSITIES Regional Univ		MEDICARE ONLY TEACHERS NO SOCIAL SEC COVG	
Pension Contribution Percentage ^a	Tier 1=5% Tiers 2 & 3 = 6%		Tier 1=8% Tiers 2 & 3 = 9%		Tier 1=5% Tier 2=6%		5.00% 8.185%		12.865% 5.0%	
CURRENT CALCULATION:										
Semi-monthly Gross Pay	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50
Less Retirement Contribution	84.38	101.25	135.00	151.88	84.38	101.25	84.38	138.12	216.93	84.38
Base Wages for FICA	1,603.13	1,586.25	1,552.50	1,535.63	1,603.13	1,586.25	1,603.13	1,549.38	1,470.57	1,603.13
FICA tax	99.39	98.35	96.26	95.21	99.39	98.35	99.39	96.06		
Medicare tax	23.25	23.00	22.51	22.27	23.25	23.00	23.25	22.47	21.32	23.25
Total FICA & Medicaid per period	122.64	121.35	118.77	117.48	122.64	121.35	122.64	118.53	21.32	23.25
NEW CALCULATION:										
Semi-monthly Gross Pay = Base wages for FICA	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50
FICA tax	104.63	104.63	104.63	104.63	104.63	104.63	104.63	104.63		
Medicare tax	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47
Total FICA & Medicaid per pay period	129.09	129.09	129.09	129.09	129.09	129.09	129.09	129.09	24.47	24.47
Total withholding increase Per Pay Period (agency & employee)	6.45	7.75	10.33	11.62	6.45	7.75	6.45	10.57	3.15	1.22

* Everyone hired after 1986 is federally mandated to pay Medicare.

^a Employee contribution percentages vary based on system, classification, tier and date-of-hire.